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Caught Between a Rock and a Soft Place: Regulating Legal Ethics to Police Corporate Governance in the United States and Hong Kong

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CAUGHT BETWEEN A ROCK AND A SOFT PLACE: REGULATING LEGAL ETHICS TO POLICE CORPORATE GOVERNANCE IN THE UNITED STATES AND HONG KONG

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Abstract: Both the United States and Hong Kong have suffered through corporate governance scandals in recent years. The two nations have tried different methods of regulating legal ethics in order to curtail future corporate governance scandals. The United States, via the Sarbanes-Oxley Act of 2002, empowered the Securities and Exchange Commission ("SEC") to dictate disclosure requirements to U.S. lawyers who represent listed corporations. This mandate creates conflicts between lawyers' duty to keep clients' secrets and their duty to disclose client information for the protection of public interests. Hong Kong took a completely different approach. The Hong Kong Stock Exchange negotiated the Memorandum of Understanding with the Hong Kong Law Society, which clarifies the scope of a solicitor's duties when practicing before the Stock Exchange. This Comment compares the United States and Hong Kong systems of regulating lawyers, specifically considering issues relating to corporate governance. It concludes that the SEC should adopt Hong Kong's style of negotiation and clarification and Hong Kong should adopt the U.S. enforcement stance and definition of the client in order to more effectively prevent corporate scandals before they start.

I. INTRODUCTION

Both the United States and Hong Kong have had serious, market-crippling corporate governance scandals in the last few years. In the United States, Enron's collapse involved a $700 million[1] loss of net earnings, $1.2 billion loss of shareholder equity, and the discovery of more than $4 billion in hidden liabilities.[2] In WorldCom's downfall, 7,500 people lost their jobs[3] and investors are eventually expected to lose over $175 billion[4] after the

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[1] All dollar amounts in this Comment are in U.S. dollars.

[2] William W. Bratton, *Enron and the Dark Side of Shareholder Value*, 76 TUL. L. REV. 1275, 1282 (2002). Enron illegitimately drove up its profits by selling and buying from its own hedge funds. *Id.*

[3] Bloomberg News, *MCI Posts Loss; Will Cut 7,500 Jobs*, N.Y. TIMES, May 11, 2004, at C7.

[4] Seth Schiesel, *No Shortage of Opinions on Salvaging WorldCom*, N.Y. TIMES, Jan. 20, 2003, at C3.

bankruptcy and bond issues are finally adjudicated.[5] While Hong Kong has not suffered similar cataclysmic collapses, Hong Kong markets and investors consistently suffer through corporate malfeasance such as BOTO[6] and, comparable to Enron and WorldCom, smaller corporate collapses such as Akai Holdings.[7] These scandals were particularly harmful to Hong Kong markets because forty percent of its 6.8 million residents are retail investors who suffered significant losses when these companies lost value.[8]

In their efforts to stave off future corporate governance scandals, both the United States and Hong Kong have focused in part on the role of lawyers, or solicitors, as they are known in Hong Kong.[9] The regulation of lawyers presents a novel avenue for policing corporate governance. Lawyers are involved in virtually every fraudulent transaction, yet due to the duty to preserve a client's confidences,[10] lawyers' actions have not previously been questioned.

In 2002, just three weeks after WorldCom declared bankruptcy,[11] the U.S. Congress passed a package of major corporate governance reforms, commonly known as the Sarbanes-Oxley Act.[12] Among other changes, the Sarbanes-Oxley Act directed the SEC to regulate the lawyers representing regulated corporations.[13] This led to a rule allowing attorneys to withdraw

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[5] *See*, Michael Shroeder, *SEC Files Civil Suit Against WorldCom*, WALL ST. J, June 27, 2002, at A3. WorldCom grossly overstated earnings for multiple cycles. *Id.*

[6] *See, e.g.*, *Governance Offers Poor View*, S. CHINA MORNING POST, Sept. 4, 2002, at 12. BOTO sold off its most profitable division at a loss to a private company owned by the CEO and used the money to purchase a failing company from another board member. Samuel Yeung, *Boto Failed to Disclose Connected Transactions*, S. CHINA MORNING POST, July 19, 2002, at 2.

[7] *See, e.g.*, Matthew Miller, Mark L. Clifford & Susan Zegel, *Dishonored Dealmaker*, BUS. WK. ONLINE, Aug. 5, 2002 [hereinafter *Dishonored Dealmaker*]; *Justice Denied in Hong Kong (Akai Holdings Ltd.)*, BUS. WK., Aug. 5, 2002, at 80. The Akai founder liquidated the corporation's assets and disappeared, probably to mainland China. *Id.*

[8] Joel Baglole, *Lowering the Bar: Hong Kong Has Missed an Opportunity to Raise its Market-Regulatory Standards to Meet Global Best Practice; While Investment Banks, Brokers and Companies Might Benefit in the Short Run as a Result, Both Investors and the City's Reputation Could Suffer Irreparable Damage*, FAR E. ECON. REV., Apr. 15, 2004, at 38.

[9] PETER WESLEY-SMITH, AN INTRODUCTION TO THE HONG KONG LEGAL SYSTEM 91, 93 (1987). Hong Kong also has barristers, who are professional litigators. *Id.* This Comment focuses only on solicitors, who do the majority of work on corporate governance issues in Hong Kong, though barristers representing corporations in litigation will have similar ethics issues.

[10] For U.S. lawyers, *see* MODEL RULES OF PROF'L CONDUCT R. 1.6; for Hong Kong Solicitors, *see* GUIDE FOR PROF'L CONDUCT ch. 8.

[11] Richard Simon, *Senate Panel Approves Reforms for Corporations Finance: Stalled Bill Gains New Urgency. It Includes Limits on Loans to Executives and Guards on Retirement Funds*, L.A. TIMES, July 12, 2002, at A20.

[12] The Public Company Accounting Reform and Investor Protection Act of 2002 (Sarbanes-Oxley Act), Pub.L. No. 107-204, 116 Stat. 745 (2002). The Sarbanes-Oxley Act was codified as various entries in the U.S.C.: 15 U.S.C. §§ 7201-02, 7211-19, 7231-34, 7241-46, 2761-66, 78o-6, 78o-3, 18 U.S.C. §§ 1348-50, 1514A, 1519, 1520.

[13] 15 U.S.C. § 7245 (2002).

from representation and reveal client confidences, a so-called "noisy withdrawal," if the client is engaging in a qualifying fraud.[14]

Hong Kong started well in advance of the United States in regulating solicitors' actions in the corporate arena. In 1996, the Law Society of Hong Kong and the Hong Kong Stock Exchange negotiated a Memorandum of Understanding ("MOU").[15] The MOU defines the expectations the Stock Exchange has for a Hong Kong solicitor representing a listed corporation and clearly defines a solicitor's duties when representing a listed company.[16] Hong Kong was also struck by recent corporate scandals and, like the United States, is working on new regulations to control corporate governance scandals. On January 20, 2004,[17] Hong Kong's Standing Committee on Company Law Reform released Phase II of its report on changes needed to Hong Kong laws to solve its corporate governance issues.[18]

In both countries, these new regulations are having unintended consequences. In the United States, three major problems have resulted. The first problem is that lawyers are now allowed to reveal previously protected client confidences.[19] Second, since state bar associations license lawyers to practice, some lawyers are trapped because their state disclosure rules now conflict with the SEC's disclosure rules.[20] Third, because states and the state supreme courts have traditionally regulated lawyers, the new federal regulations evoke federalism and preemption concerns.[21]

Because the MOU envisions cooperation between the regulating entities, Hong Kong would seem to have started off in a better position than the United States. Hong Kong, however, faces four serious issues. First, the

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[14] 17 C.F.R. § 205 (2003).

[15] GUIDE TO PROF'L CONDUCT, ch. 15: Memorandum of Understanding ("MOU") between the Law Society of Hong Kong and the Stock Exchange of Hong Kong (Dec. 18, 1996), *available at* http://www.hklawsoc.org.hk/pub_e/professionalguide/ch15/ (last visited Jan. 14, 2005) [hereinafter MOU].

[16] *Id.*

[17] Press Release, Standing Committee on Company Law Reform, SCCLR Issues Final Recommendations from Corporate Governance Review Phase II (Jan. 20, 2004), *available at* http://www.info.gov.hk/cr/message/040120.htm (last visited Jan. 14, 2005).

[18] STANDING COMMITTEE ON COMPANY LAW REFORM, CORPORATE GOVERNANCE REVIEW - A CONSULTATION PAPER ON PROPOSALS MADE IN PHASE II OF THE REVIEW (June 2003), *available at* http://www.info.gov.hk/cr/download/scclr/cgr2_e.pdf (last visited Jan. 14, 2005) [hereinafter PHASE II REPORT]. Phase I of the report was released in July 2001. STANDING COMMITTEE ON COMPANY LAW REFORM, CORPORATE GOVERNANCE REVIEW - A CONSULTATION PAPER ON PROPOSALS MADE IN PHASE I OF THE REVIEW (July 2001), *available at* http://www.info.gov.hk/cr/download/scclr/Rpt_e.pdf (last visited Jan. 14, 2005) [hereinafter PHASE I REPORT].

[19] 17 C.F.R. § 205 (2003).

[20] For examples, see discussion *infra* Part II.C.4.

[21] There are also issues with the separation of powers, as the SEC is part of the federal executive branch while the state bar associations are parts of the state judicial branches and answer to the state supreme courts. However, these issues are outside the scope of this Comment.

MOU has never been used to discipline a solicitor, even though the recent scandals should have produced numerous opportunities to do so.[22] Second, Hong Kong investors have far fewer protections than U.S. investors.[23] Like most Asian markets and unlike most U.S. corporations, Hong Kong companies are typically family-owned or closely-held, which creates a treacherous investment environment for minority shareholders.[24] Thirdly, the Hong Kong Securities and Futures Commission ("SFC") does not investigate and pursue violating companies in the same way as the SEC.[25] The SFC reviews company documents before they are released, which changes the character of the SFC from enforcement to auditing.[26] Finally, unlike U.S. lawyers, who have the Model Rule of Professional Conduct 1.13 to define their duties to corporate clients,[27] Hong Kong solicitors who represent corporations have no such rule defining their duties.[28] The professional rules of the Hong Kong Law Society do not clearly differentiate who the client is and to whom the solicitor owes the duty of confidentiality.[29]

Both the United States and Hong Kong should learn from each other's regulatory activities. Each country has tried distinctly different approaches to policing corporate governance by regulating legal professionals. In the United States, improving cooperation between regulating entities and clarifying lawyers' obligations under both federal and state rules similar to what Hong Kong has done with the MOU could strengthen the SEC regulations. Hong Kong would be aided by a change in the tenor and timing of enforcement of existing regulations, as well as by a clear definition of the client for solicitors representing corporations.

This Comment examines and compares the two different methods of regulating lawyers in order to prevent corporate governance scandals. Part II discusses the corporate governance problems facing the two markets and

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22 *From the Council Table: MOU with the Stock Exchange*, H.K. LAW., March 2004, *available at* http://www.hk-lawyer.com/2004-3/Default.htm (under "Law Society News") (last visited Jan. 14, 2005) [hereinafter *From the Council Table I*].

23 Say H. Goo & Rolf H. Weber, *The Expropriation Game: Minority Shareholders' Protection*, 33 H.K. L. J. 71, 84-87, 93-97 (2003) [hereinafter *The Expropriation Game*].

24 *Id.* at 71.

25 SFC, THE SECURITIES AND FUTURES COMMISSION OF HONG KONG: WHOM AND HOW WE REGULATE (Oct. 10, 2004), *at* http://www.hksfc.org.hk/eng/bills/html/index/index0.html (last visited Jan. 14, 2005).

26 SFC, INTRODUCING THE SECURITIES AND FUTURES COMMISSION OF HONG KONG, (Dec. 7, 2004), *at* http://www.sfc.hk/sfc/html/EN/aboutsfc/intro/intro.html (last visited Jan. 14, 2005). *See also* HONG KONG STOCK EXCHANGE, INTRODUCTION TO REGULATORY FRAMEWORK (Mar. 28, 2004), *at* http://www.hkex.com.hk/rulereg/introreg/introreg.htm (last visited Jan. 14, 2005).

27 MODEL RULES OF PROF'L CONDUCT R. 1.13 (2003).

28 *See infra* Part III.C.2.

29 *Id.*

how regulating lawyers could have prevented or mitigated past scandals. Part III reviews the passage of the Sarbanes-Oxley Act, the legal profession's reaction to Sarbanes-Oxley, and the effectiveness of Sarbanes-Oxley regulation of lawyers. Part IV examines Hong Kong's negotiated system of regulating lawyers and the creation of the MOU, as well as the MOU's effectiveness in light of Hong Kong corporate governance issues. Part V compares the two systems, demonstrating how each system would benefit from the other's methods. Finally this Comment concludes by extrapolating the potential results of these proposed policy changes.

II. THE UNITED STATES ATTEMPTS TO CURE CORPORATE GOVERNANCE ISSUES BY REGULATING LAWYERS

Following the collapse of major U.S. corporations, the corporate governance system in the United States was overhauled by the Sarbanes-Oxley Act of 2002. A key component of the Sarbanes-Oxley Act is the regulation of lawyers.[30] Regulating lawyers is a novel and controversial step in corporate governance regulation for the United States. Legal ethics in the United States have always been the purview of the individual state bar associations and state supreme courts.[31] It is not yet clear whether a lawyer following the rules derived by the SEC in accordance with the Sarbanes-Oxley disclosure rules will be in violation of a state's rules of conduct for lawyers.[32] Even though the American Bar Association ("ABA") has adopted similar Model Rules of Professional Conduct ("Model Rules") as the SEC, the individual states continue to debate whether the SEC rules are in conflict with or trump state rules. Regardless of the debate and the permissive nature of the rules, the recent example of TV Azteca demonstrates the possible effectiveness of the new rules.

A. *The Sarbanes-Oxley Act Is Enacted to Try to Solve Corporate Governance Problems*

The Sarbanes-Oxley Act did not invent the idea of using lawyers to regulate corporate governance. The ABA first approached using lawyers to address corporate governance issues when the Ethics 2000 Commission,

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30 Sarbanes-Oxley Act § 307, 15 U.S.C. § 7245 (2002).

31 The notable exception is practicing before the patent bar. This exception to state's rights was upheld in *Sperry v. State of Florida*, 373 U.S. 379 (1963).

32 *See, e.g.*, Open Memorandum from the California Bar Association's Business Law Section Corporations Committee, in response to the SEC's public letter to the Washington State Bar Association (July 23, 2003) (on file with author).

chaired by Delaware Supreme Court Chief Justice E. Norman Veasey,[33] recommended rules allowing lawyers to report up the ladder[34] and then noisily withdraw[35] if needed.[36] The ABA House of Delegates rejected this recommendation in August 2001.[37] During the Congressional debates in July 2002 on the Sarbanes-Oxley Act, Senator John Edwards commented:

> This amendment is about making sure . . . lawyers . . . don't violate the law and . . . ensure that the law is being followed. Unfortunately, the actions of some attorneys have drawn increasing scrutiny and criticism in light of recent events demonstrating that at least some lawyers have forgotten their responsibility.[38]

Senator Edwards added an amendment to regulate lawyers, ordering the SEC to draft rules that allow lawyers to report up the ladder.[39] The Sarbanes-Oxley Act[40] worked its way through Congress during the inquiries following the Enron collapse, but stalled until WorldCom declared bankruptcy.[41] It was passed three weeks later[42] and became effective as of August 2002.

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[33] Chief Justice Veasey heads the Supreme Court of Delaware, which is the U.S. state most associated with corporate laws. For more on Delaware's primacy on corporate laws, see, e.g., Albert Crenshaw, *Delaware Inc.*, WASH. POST, May 7, 2000, at H1; Marcel Kahan & Ehud Kamar, *The Myth of State Competition in Corporate Law*, 55 STAN. L. REV. 679 (2002).

[34] "Up the ladder" is a process where a lawyer or law firm, after discovering credible evidence of a material violation, reports the violation first to the corporation's managers, then to the executives, and finally to the board of directors. For an excellent explanation of the process, see Karl A. Groskaufmanis, *Climbing "Up the Ladder": Corporate Counsel and the SEC's Reporting Requirement for Lawyers*, 89 CORNELL L. REV. 511, 518-19 (Jan. 2004) [hereinafter *Climbing Up the Ladder*].

[35] "Noisy withdrawal" is a process whereby a lawyer or law firm, after exhausting the remedies available by reporting up the ladder, withdraws from representing the corporation, notifies the SEC of their withdrawal, and disaffirms any previous SEC filings made for that corporation that the lawyer or law firm believes to be materially false or misleading. *Id.* at 519-520.

[36] E. Norman Veasey, *The New Model Rules of Professional Conduct, the Ethics 2000 Recommendations, Congressional Activity and Concerns Over Federalism*, THE BENCHER, Nov./Dec. 2002, at 15-18.

[37] Information about the House of Delegate's amendments to the Ethics 2000 Commission's recommendations in August 2001 is available at http://www.abanet.org/cpr/e2k-summary_2002.html (last visited Jan. 14, 2005).

[38] *See* 148 CONG. REC. S6524 (daily ed. July 10, 2002) (statement of Senator John Edwards).

[39] 17 C.F.R. § 205 (2003).

[40] The Public Company Accounting Reform and Investor Protection Act of 2002 (Sarbanes-Oxley Act), Pub.L. No. 107-204, 116 Stat. 745 (2002).

[41] *See* Tom Hamburger, Greg Hitt & Michael Schroeder, *Sorry, Wrong Number: WorldCom Case Boosts Congress in Reform Efforts*, WALL ST. J., June 27, 2002, at A8.

[42] *Id.*

The Sarbanes-Oxley Act added various internal checks-and-balances to the tracking of a listed corporation's finances.[43] These included substantial additions to the duty of care for the Chief Executive Officer ("CEO"),[44] Chief Financial Officer ("CFO"),[45] and other Senior Finance Officers,[46] as well as requiring CEOs and CFOs to personally sign-off on public financial statements and enacting individual penalties when these financial reports are amended.[47] It also included requirements for outside auditing committees[48] and extensive changes to accounting standards and accountability.[49]

For the first time, however, Sarbanes-Oxley combined securities regulation and corporate governance requirements with the regulation of a lawyer's ethical duties. Sarbanes-Oxley section 307 ordered the SEC to begin regulating lawyers by promulgating a new rule:

> (1) requiring an attorney to report evidence of a material violation of securities law or breach of fiduciary duty or similar violation by the company or any agent thereof, to the chief legal counsel or the chief executive officer of the company (or the equivalent thereof); and
> (2) if the counsel or officer does not appropriately respond to the evidence (adopting, as necessary, appropriate remedial measures or sanctions with respect to the violation), requiring the attorney to report the evidence to the audit committee of the board of directors of the issuer or to another committee of the board of directors comprised solely of directors not employed directly or indirectly by the issuer, or to the board of directors.[50]

If a lawyer finds an irregularity, the lawyer can notify the corporation's officers up the chain of command as high as the chief executive officer or the board of directors.[51] These types of inter-organizational notifications are not considered a breach of the attorney-client confidentiality or a conflict of interest because the organization is the client, not the wrong-doing officer or

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43 15 U.S.C. §§ 7201, 7211, 7213, 7241, 7242, 7261, 7265; 18 U.S.C § 1350 (2002).
44 18 U.S.C. § 1350 (2002).
45 15 U.S.C. §§ 7264, 18 U.S.C. 1350 (2002).
46 *Id.*
47 18 U.S.C. § 1350 (2002).
48 15 U.S.C. §§ 7201, 7211, 7213, 7241, 7242 (2002).
49 *Id.* §§ 7213, 7218.
50 *Id.* § 7245.
51 *Id.*

board member.[52] If the chief corporate officers and non-independent board members do not respond by fixing the problem, the lawyer is then authorized to notify the newly required external audit committees.[53]

The SEC took Sarbanes-Oxley a step farther, however, when it drafted the required rule. If the issue is not sufficiently resolved internally, and if the fraudulent actions will cause significant financial or property harm to a third party, and the lawyer's services were used in perpetrating the fraud, then, and only then, the lawyer may instigate a noisy withdrawal.[54] In a noisy withdrawal the lawyer or law firm announces to the board that they are no longer representing the firm, notify the SEC of this action within one day, and, finally, disaffirm any SEC filings that the law firm now believes are suspect, effectively revealing the client's confidences.[55]

B. *The American Bar Association Opts for Unity with the SEC in the Revised Model Rules of Professional Conduct*

U.S. lawyers are licensed to practice in each individual state, not in the nation as a whole. Each state has its own bar association that maintains its own rules regulating lawyer conduct. The ABA is a national organization in which lawyers participate voluntarily.[56] The ABA does not actually regulate lawyers, but influences the growth and standards of the legal profession in the United States.[57] The ABA first drafted a Model Code of Professional Conduct as a suggestion to the state bar associations as to what their state codes should be.[58] The ABA replaced the Model Code of Professional Conduct with the Model Rules of Professional Conduct ("Model Rules") in 1983.[59] The Model Rules, like the Model Code of Professional Conduct, were not binding on any lawyer in any state. Many state bar associations also switched from the Model Code of Professional

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[52] *Id.*

[53] *Id.*

[54] 17 C.F.R. § 205 (2003).

[55] *Id.*

[56] "The ABA is a voluntary national professional association with no legal authority to adjudicate or intervene in lawyer licensing or disciplinary matters. To file a complaint against a lawyer, contact the appropriate state agency for assistance." AMERICAN BAR ASSOCIATION CENTER FOR PROFESSIONAL RESPONSIBILITY, INFORMATION FOR THE PUBLIC, *available at* http://www.abanet.org/cpr/public_info.html (last visited Jan. 14, 2005).

[57] *Id.*

[58] MODEL CODE OF PROFESSIONAL RESPONSIBILITY, Preamble, *available at* http://www.abanet.org/cpr/ethics/mcpr.pdf (last visited Jan. 14, 2005).

[59] AMERICAN BAR ASSOCIATION, ADOPTION HISTORY OF THE MODEL RULES OF PROFESSIONAL CONDUCT, *at* http://www.abanet.org/cpr/mrpc/mrpc_home.html (last visited Jan. 14, 2004).

Conduct to the Model Rules. Some did not switch and still operate under their version of the Model Code of Professional Conduct.[60]

The Model Rules were extensively revised in 2000 by the ABA's Commission on the Evaluation of the Rules of Professional Conduct ("Ethics 2000").[61] Delaware Supreme Court Chief Justice E. Norman Veasey chaired the Ethics 2000 Commission, which is significant because the State of Delaware is renowned for its corporate laws.[62] The Ethics 2000 Commission proposal contained, among many other changes, revisions to two key rules: Model Rule 1.6 (Confidentiality)[63] and Model Rule 1.13 (Organization as a Client).[64] The proposed changes were very similar to the language eventually used in Sarbanes-Oxley and in the resulting SEC regulations. The ABA House of Delegates initially rejected the Ethics 2000 recommendations on Model Rules 1.6 and 1.13,[65] but after the passage of Sarbanes-Oxley and the implementation of the SEC regulations in 2002, the ABA House of Delegates and membership adopted the Ethics 2000 Commission's recommendation on August 6, 2003.[66]

The state bar associations, triggered by the Ethics 2000 Commission's revision of the Model Rules, are currently in different stages of reviewing their own Rules of Professional Conduct.[67] While there is a strong push for national uniformity, federalism concerns continue to block standardization of state legal ethics.[68]

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60 Most notably New York still uses the Code of Professional Conduct system. *See* New York Lawyer's Code of Professional Responsibility, *available at* http://www.nysba.org/Content/NavigationMenu/Attorney_Resources/Lawyers_Code_of_Professional_Responsibility/LawyersCodeOfProfessionalResponsibility.pdf (last visited Jan. 14, 2005). Some other states have not been guided by the ABA at all. California's rules are not modeled on any ABA suggestions. *See* California Rules of Professional Conduct, *available at* http://www.calbar.ca.gov/state/calbar/calbar_generic.jsp?sCategoryPath=/Home/Attorney%20Resources/Rules%20%26%20Regulations/Rules%20of%20Professional%20Conduct (last visited Jan. 14, 2005).

61 Information on the Ethics 2000 Commission, its work, and its report is available at http://www.abanet.org/cpr/ethics2k.html (last visited Jan. 14, 2005).

62 *See, e.g.*, Crenshaw, *supra* note 33; Kahan & Kamar, *supra* note 33.

63 MODEL RULES OF PROF'L CONDUCT R. 1.6 (2003).

64 *Id.* R. 1.13.

65 Information about the House of Delegate's amendments to the Ethics 2000 Commission's recommendations in August 2001 is available at http://www.abanet.org/cpr/e2k-summary_2002.html (last visited Jan. 14, 2005).

66 Press Release, ABA Adopts New Lawyer Ethics Rules, Urges Fairness in Military Commission Trials, Policies Also Address USA PATRIOT Act, Funding for First Responders to Terrorism (Aug. 12, 2003), *available at* http://www.abanews.org/aug03/081203_1.html (last visited Jan. 14, 2005).

67 Progress on the adoption is available at http://www.abanet.org/cpr/mrpc/alpha_states.html (last visited Jan. 14, 2005). Note that the chart only indicates where the states are in the process of review, it does not note whether the states chose to adopt the ABA Model Rule language.

68 Robert A. Creamer, *Form over Federalism: The Case for Consistency in State Ethics Rules Formats*, PROF. LAW., Spring 2002, *available at* http://www.abanet.org/cpr/e2k/conventions2.pdf (last visited Jan. 14, 2005). See *infra* Part II.C.3 for further discussion of federalism conflicts.

1. *Model Rule 1.6 (Confidentiality)*

Model Rule 1.6 (Confidentiality) governs lawyers whether the client is an individual or a corporation. For either type of client, a lawyer may only divulge client confidences in defined exceptional circumstances. All these exceptions are permissive, including when the lawyer is acting to prevent reasonably certain death or substantial bodily harm.[69]

The key provisions for corporate governance are Model Rule 1.6(b)(2), (3), and (6). Model Rule 1.6(b)(2) allows a lawyer to disclose confidences to prevent clients from using the lawyer's services in furtherance of a fraud.[70] Model Rule 1.6(b)(3) allows the lawyer to disclose client confidences to rectify, mitigate, or prevent the fraud in furtherance of which the client used the lawyer's services.[71] Under these two rules the lawyer can only disclose if the client abused the attorney-client relationship. If the lawyer is hired to defend against the fraud claim or if the client did not use the lawyer's services to perpetrate the fraud, according to Model Rule 1.6(a), the lawyer may not disclose the fraud.[72]

Finally, Model Rule 1.6(b)(6) allows "other law" to regulate a lawyer's conduct.[73] This highly debated language[74] allows regulations like Sarbanes-Oxley and agencies like the SEC to regulate lawyer conduct, even though this task was previously delegated only to the state bar associations.[75]

2. *Model Rule 1.13 (Organization as a Client)*

Model Rule 1.13 (Organization as Client) is crucial to lawyers representing corporations.[76] Model Rule 1.13 specifies that the lawyer represents the organization, not its officers, employees, or other persons

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[69] MODEL RULES OF PROF'L CONDUCT R. 1.6.
[70] *Id.* R. 1.6(b)(2).
[71] *Id.* R. 1.6(b)(3).
[72] *Id.* R. 1.6(b)(2), (3).
[73] *Id.* R. 1.6(b)(6).
[74] For an extensive discussion of the "other law" language issues, see Minutes from the January 31, 2004, WSBA Ethics 2003 Committee; Presentation of Professor Thomas R. Andrews, Professor of Law at the University of Washington, *available at* http://www.wsba.org/lawyers/groups/ethics2003/appendixe.doc (last visited Jan. 14, 2005).
[75] Patent law is the notable exception to the state's power to regulate lawyers. *See Sperry v. State of Florida*, 373 U.S. 379 (1963).
[76] Chief Justice Veasey wrote, "A proper reading of Model Rule 1.13 makes it clear that in the serious corporate fraud case the lawyer must act promptly to prevent the fraud by going up the chain of command to the board of directors if necessary. In most instances the lawyer representing the corporation who successfully goes up the Rule 1.13 chain of command and stops the malfeasance, or whose 'noisy withdrawal' permitted by Rules 1.6 and 1.13 sends up red flags for the world to see, will have avoided the need to disclose his client's confidences outside the organization." Veasey, *supra* note 36, at 16.

associated with the organization.[77] If the lawyer knows that one of these individuals is acting or intends to act in a way that violates the law or a legal obligation, then the lawyer can notify other members of the corporation, including the highest members.[78] If the highest members of the corporation do not respond in a timely or appropriate manner, then the lawyer can reveal client confidences only to the extent needed to prevent substantial injury to the corporation.[79] If the lawyer was fired for reporting up the ladder, the lawyer may continue to represent the corporation by notifying the highest members of the corporation of the fraud committed by the underlings.[80]

C. *The Sarbanes-Oxley Act and the Revised Model Rules Cause Conflict and Confusion*

Sarbanes-Oxley has left both lawyers and corporations confused. Corporations and lawyers are trying to cope with the new strict requirements for outside boards, independent auditors, and greater CEO and CFO involvement.[81] Corporations are being driven out of the market.[82] SEC enforcements are much harsher and harder to predict under the new rules.[83]

Lawyers find themselves in a profoundly conflicted position. They must now choose whether to reveal client confidences and, regardless of their choice, may be disciplined because the new SEC rules and the rules of professional conduct of the state in which they practice may disagree. State bar associations are bristling as the SEC attempts to regulate lawyers and the SEC is taking a heavy-handed approach to the state bar associations.[84]

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[77] MODEL RULES OF PROF'L CONDUCT R. 1.13(a)-(b).

[78] *Id.* R. 1.13(b).

[79] *Id.* R. 1.13(c).

[80] *Id.* R. 1.13(e).

[81] The 2004 Annual Meeting of the ABA's Business Law Section included seminars entitled "The Evolving Relationship with Auditors in the New Corporate Environment: Trusted Advisors or Foes?", "Lawyers Caught in the Enron Spotlight," "What's So Hot About Going Private? Nuts and Bolts of Taking a Public Company Private," "Enron's Lessons for Investment Bankers, Accountants, Attorneys and Other Advisers," "Components of Effective Ethics Training for Corporate Compliance," and "Wanted: Corporate Directors Who Are Not Afraid to Face Millions of Dollars of Personal Liability Since We Cannot Afford D&O Insurance." American Bar Association, Business Law Spring 2004 Conference Course Listings (on file with author).

[82] *See, e.g.*, Jeremy Khan, *The Burden of Being Public; Bound By New Regulations and Changes on Wall Street, More Firms Are Breaking Free—By Going Private*, FORTUNE, May 26, 2003, at 35.

[83] Stephen Labaton, *S.E.C. Feels Pressure to Weaken Some Rules*, N.Y. TIMES, May 10, 2004, at C1.

[84] *See infra* Part II.C.4.

1. *Confusion for Corporations and Lawyers About Corporate Governance and the New Expenses of Being a Listed Corporation*

Compliance with the rules in Sarbanes-Oxley is expensive and resource consuming for both corporations and lawyers. A recent trend among small to medium sized businesses is "going private," or applying for delisting.[85] This complex process often involves buying out minority shareholders at a premium, but the costs of the buyout can be much cheaper than the costs of complying with the Sarbanes-Oxley requirements.[86]

There is also a limited number of persons willing to be independent auditors. Professionals who may qualify as independent auditors for a corporation are declining because of rising liability insurance costs or because of higher sensitivity to possible conflicts of interest.[87] These professionals are now requiring higher compensation commensurate with the greater personal risk and responsibility.[88] Again, this prices many smaller and mid-sized companies out of the possibility of compliance.

For lawyers, the risks of representing corporations under the new disclosure requirements have increased. Mark A. Belnick, the lawyer for Tyco Corporation, was sued by the SEC for his actions related to the corporate governance abuses at TYCO and the SEC investigation of TYCO CEO Dennis Koslowski.[89] Belnick was acquitted by a jury, but only after a long and costly litigation.[90] The lawyers in the TV Azteca case are not being

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[85] *See, e.g.*, Carrie Coolidge, *Who Needs The Aggravation?; With Stricter Federal Accounting Laws, Microcaps Eye Going Private*, FORBES, Oct. 14, 2002, at 56; Robert Clow, *Groups May Delist to Avoid Tougher SEC Rules*, FIN. TIMES, Oct. 24, 2002, at P30; Laura K. Thompson, *A (Going) Private Matter—Why More Public Firms Should Consider Delisting*, ECONOMIST, March 22, 2003; Andrew Dolbeck, *New Accounting Rules Drive Privatization Deals*, WKLY. CORP. GROWTH REP., Apr. 21, 2003, at 1; Tim Reason, *Off the Street: Stricter Rules and Wary Investors are Prompting More Companies to Exit the Public Markets*, CFO, May 1, 2003, at 54; Deborah Lohse, *Struggling Firms Decide to Go Private*, SAN JOSE MERCURY NEWS, May 8, 2003, at 12; Mark Cecil, *Sarbanes-Oxley Propels More Small Companies To Go Private*, MERGERS & ACQUISITIONS REP., May 19, 2003; Khan, *supra* note 82; Josh Friedman, *More Companies Find It's Better to Go Private*, L.A. TIMES, May 27, 2003, at C1.

[86] For an example of a company that went private, see the Cobalt Group privatization. Press Release, The Cobalt Group, Inc. Announces Completion of Going-private Transaction (Nov. 13, 2001), *available at* http://www.cobaltgroup.com/press/pr/press_release-011113.jsp (last visited Jan. 14, 2005).

[87] Thompson, *supra* note 85.

[88] Richard H. Guifford & Harry Howe, *Regulation and Unintended Consequences: Thoughts on Sarbanes-Oxley*, CPA J. ONLINE (June 4, 2004), *at* http://www.nysscpa.org/cpajournal/2004/604/perspectives/p6.htm (last visited Jan. 14, 2005).

[89] Laurie P. Cohen, *Tyco's Former Top Lawyer Joins CEO on Hot Seat*, WALL ST. J., Sept. 13, 2002, at C1.

[90] Jonathan D. Glater, *Jury Finds Ex-Tyco Lawyer Not Guilty of All Charges*, N.Y. Times, July 16, 2004 at C1.

sued by the SEC; instead they are being sued by their former client for disclosing that client's alleged misconduct to the SEC.[91]

2. *The SEC Heightens Corporations' and Lawyers' Fears by Taking a Strong Enforcement Stance*

The SEC's enforcement stance since Sarbanes-Oxley has greatly increased the risks to both corporations and their lawyers for any kind of non-compliance. Empowered by the congressional backing implicit in the passage of such a far-reaching bill as Sarbanes-Oxley, the SEC has become much more aggressive in going after companies and much less forgiving in sanctions.[92] In June 2001, just a month pre-Sarbanes-Oxley, the SEC fined Arthur Andersen a record $7 million for accounting fraud.[93] Post-Sarbanes-Oxley, the SEC has imposed penalties ranging from $10 million against Xerox[94] to $50 million against Vivendi,[95] to $750 million against WorldCom.[96] These judgments also come on top of sizeable disgorgements by both the corporations and the individual officers.[97]

For lawyers, monetary and criminal penalties from SEC actions are not the only consequences. A lawyer may also be sanctioned by the state bar association, which may include disbarment. These career-limiting or career-ending sanctions would be in addition to any SEC criminal charges or financial penalties. Lawyers caught in the SEC's aggressive enforcement practices may have to choose between their freedom or their career.

3. *Client Confidentiality Under Attack*

Client confidentiality is the foundation of any attorney-client relationship.[98] The new SEC rules and ABA Revised Model Rules are chipping away at the protection of client confidences. According to Sandra

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91 *See infra* Part II.D (Case Study: TV Azteca).

92 *Climbing Up the Ladder*, *supra* note 34, at 522.

93 Michael Schroeder, *SEC Fines Arthur Andersen in Fraud Case: Big 5 Firm to Pay $7 Million After Inquiry of Audits For Waste Management*, WALL ST. J., June 20, 2001, at A3. While the SEC fines in the 1980's against Michael Milken totaling $447 million and his former employer, Drexel Burnham Lambert, for $350 million were record setters, they were also anomalies. The judgment against Arthur Andersen was not seen as a similar outlier, but as a record-setting fine. *Id.*

94 *SEC v. Xerox Corporation*, Litigation Release No. 17465, Release No. AE - 1542, 77 S.E.C. Docket 971, 2002 WL 535379 (S.E.C. Release No.) (Apr. 11, 2002).

95 *SEC v. Vivendi*, Litigation Release No. 18523, Release No. AE - 1935, 81 S.E.C. Docket 3043, 2003 WL 23013258 (S.E.C. Release No.) (Dec. 24, 2003).

96 *SEC v. WorldCom*, Litigation Release No. 17866, Release No. AE - 1678, 2002 WL 31662699 (S.E.C. Release No.) (Nov. 26, 2002).

97 15 U.S.C. §§ 7246, 77t(d)(3)(A) (2002).

98 MODEL RULES OF PROF'L CONDUCT R. 1.6, cmt. 2 (2003).

J. Harris, Director of the Pacific Regional Office of the SEC, the SEC values cooperation by the embattled corporation more than anything else in making prosecution decisions.[99] Cooperation with the SEC affects the SEC's charging decisions, remedies sought, and criminal charges leveled.[100] Ms. Harris cited the HomeStore case,[101] in which the company immediately notified the SEC of possible wrongdoing, did an independent and thorough audit, gave the audit results to the SEC, waived attorney-client privilege, fired the wrongdoers, and added new controls to prevent future similar abuses.[102] Due to the company's swift and extensive actions, the SEC did not prosecute the company as a whole, even though eleven individuals were criminally charged.[103] If waiving attorney-client privilege is what the SEC means by "cooperation," then lawyers throughout the United States should be concerned about any attack by the SEC on confidentiality. If every company were as cooperative as HomeStore, the SEC would be obsolete.

U.S. lawyers no longer know to what extent their representation of their client corporations is protected. The language "rectify, mitigate, and prevent"[104] from the ABA Model Rules is particularly concerning as there are no guidelines as to what actions rectify, to what extent must they mitigate, or what prevention measures are required.[105] To effectively have attorneys aid in controlling corporate governance abuses, the rules need to be clear and the duties non-conflicting. This will not happen until the SEC and the state bar associations negotiate effectively with each other.

4. *Conflict of Rules between the SEC and State Bar Associations*

The new rules regulating lawyers has caused controversy in the U.S. legal profession. State bar associations argue that pre-emption and federalism prevent the SEC from regulating a lawyer's conduct.[106] In the

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[99] Ms. Harris's comments were made at a seminar entitled "A Business Lawyer's Primer on Hot Topics in SEC Enforcement," presented jointly by the ABA Committee on Federal Regulation of Securities and the ABA Committee on State Regulation of Securities, Apr. 1, 2004, at the ABA Business Law Section Annual Conference. This report is available for ABA members at http://www.abanet.org/buslaw/mo/premium-cl/programs/spr04/17/17.pdf (last visited Jan. 14, 2005) (on file with the author).

[100] *Id.*

[101] *SEC v. Sophia M. Kabler*, Litigation Release No. 18355, Release No. AE - 1864, 81 S.E.C. Docket 367, 2003 WL 23305808 (S.E.C. Release No.) (Sept. 18. 2003).

[102] *See* Harris, *supra* note 99.

[103] *SEC v. Gieseck*, Litigation Release No. 17745, Release No. AE - 1636, 78 S.E.C. Docket 1494, 2002 WL 31121375 (S.E.C. Release No.) (Sept. 25, 2002).

[104] MODEL RULES OF PROF'L CONDUCT R. 1.6(b)(6).

[105] *Id.*

[106] Letter from the California Bar Assn's Bus. L. Sec. Corp. Committee, to Giovanni P. Prezioso, General Counsel, U.S. Securities and Exchange Commission (August 13, 2003) (on file with author). *See*

Congressional debate over the amendment adding lawyer accountability to the Sarbanes-Oxley bill, Senator Michael Enzi said:

> I am usually in the camp that believes that [s]tates should regulate professionals within their jurisdiction. However, in this case, the [s]tate bars as a whole have failed. They have provided no specific ethical rule of conduct to remedy this kind of situation. Even if they do have a general rule that applies, it often goes unenforced.[107]

As a result of ABA's Ethics 2000 Commission's work, most state bar associations are in the process of reviewing their ethics rules and many are choosing either not to accept the revised disclosure rules or to adopt a further revised version.[108] The Washington State Bar Association issued an Interim Formal Ethics Opinion stating that lawyers would be held to the state bar disclosure rules and not the SEC rules, therefore prohibiting lawyers from noisily withdrawing while ensuring the protection of client confidences.[109] The SEC responded in an open letter stating that any lawyer practicing before the SEC would be subject to the Sarbanes-Oxley rules regardless of state bar sanctions and that federal regulations trump state bar rules.[110] The Corporations Committee of the Business Law Section of the California Bar Association responded to the SEC's public letter with an open letter supporting Washington's Interim Formal Ethics Opinion.[111] The Washington State Bar Association also responded, requesting a compromise with the SEC: "[the Washington State Bar Association] trust[s] that the harmonization of the SEC's permissive disclosure rule with adherence to the Washington Rules of Professional Conduct . . . best meets our respective

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also Committee of the Bus. L. Sec. and Committee on Prof. Responsibility and Conduct, *Ethics Alert: The New SEC Attorney Conduct Rules v. California's Duty of Confidentiality Corporations* [hereinafter *Ethics Alert*], *available at* http://www.calbar.ca.gov/calbar/pdfs/SEC-ethics-alert.pdf (last visited Jan. 14, 2005).

[107] 148 CONG. REC. at S6524 (daily ed. July 10, 2002) (statements by Senator Michael Enzi).

[108] Most notably California and Washington. The California Bar Association issued an Ethics Alert about the SEC rules. *See* Ethics Alert *supra*, note 106.

[109] Wash. State Bar Ass'n Board of Governors, Interim Formal Ethics Opinion Re: The Effect of the SEC's Sarbanes-Oxley Regulations on Washington Attorneys' Obligations Under the RPCs (July 26, 2003), *available at* http://www.wsba.org/lawyers/groups/ethics2003/formalopinion.doc (last visited Jan. 14, 2005).

[110] Giovanni P. Prezioso, Public Statement by SEC Official: Letter Regarding Washington State Bar Association's Proposed Opinion on the Effect of the SEC's Attorney Conduct Rules (July 23, 2003), *available at* http://www.sec.gov/news/speech/spch072303gpp.htm (last visited Jan. 14, 2005).

[111] Letter from the California Bar Association's Bus. L. Sec. Corp. Committee, to Giovanni P. Prezioso, General Counsel, U.S. Securities and Exchange Commission (August 13, 2003) (on file with author).

goals and obligations."[112] The Washington State Bar Association's Ethics 2003 Committee, which was reviewing the revised Model Rules, final recommendation on the Model Rules was not compliant with the SEC rule.[113] This recommendation was accepted by the Washington State Bar Association's Board of Governors[114] and has been presented to the Washington State Supreme Court. Whether the SEC chooses to litigate against lawyers in Washington or California has yet to be seen.

5. The SEC Rule is Ineffective Because It is Not Mandatory

The permissive nature of the SEC rule and the ABA Model Rules, as demonstrated by the language of "may" in the rules instead of "must" or "will," significantly dilutes both rules. This benefits lawyers who want to protect their clients' secrets. Whether to take any action, be it reporting up the ladder, reporting out to an audit board, or noisily withdrawing, is up to the lawyer.

Internal clauses and disclaimers also soften the rule. First, it applies only to frauds in which the lawyer's services were used,[115] not frauds that the lawyer discovers in the due course of representing the company.[116] Also, those frauds must be likely to cause significant financial or property harm to a third party.[117] If the harm is not assured, not significant, or the harm does not affect the finances or property of a third party or the corporation itself, the lawyer may not disclose.[118]

Finally, the noisy withdrawal process is diluted as well. The lawyer or law firm only moves on to the next level if they fail to get an "adequate response."[119] "Adequate response" is never defined; it is discretionary to the lawyer. If informing the directors and officers does not resolve the problem, the lawyer's next recourse is to present the issue to the independent auditors.[120] While the auditors are independent, they have been chosen by

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[112] Letter from Richard Manning, President of the Wash. State Bar Ass'n, to Givoanni P. Prezioso, General Counsel, U.S. Securities and Exchange Commission (August 11, 2003), *available at* http://www.wsba.org/lawyers/groups/ethics2003/manninglettertosec.doc (last visited Jan. 14, 2005).

[113] The Ethics 2003 Committee's final recommendations are available at http://www.wsba.org/lawyers/groups/ethics2003/ (last visited Jan. 14, 2005).

[114] The Board of Governor's revisions and recommendations to the Washington State Supreme Court are available at http://www.wsba.org/lawyers/groups/ethics2003/boardofgovernorsrevisionswithcomments.doc (last visited Jan. 14, 2005).

[115] MODEL RULES OF PROF'L CONDUCT R. 1.6(b)(2), (3).

[116] *Id.*

[117] *Id.*

[118] *Id.*

[119] 17 C.F.R. § 205.3 (2003).

[120] *Id.*

the board and the same officers who did not adequately respond to the lawyer's concerns. It is only after these onerous and time-consuming steps that the lawyer may finally disclose confidences to the authorities, but again only to the extent necessary to prevent the fraud.[121] Most lawyers will find a way to silently withdraw well before this point.

D. *Case Study: TV Azteca*

Despite these problems, lawyers have been able to use noisy withdrawals to expose and reduce corporate fraud, such as in the TV Azteca case. On December 24, 2003, one of the first noisy withdrawal cases splashed across the business pages of the New York Times.[122] On December 12, 2003, the firm of Akin Gump Strauss Hauer & Feld informed the TV Azteca board of directors and federal regulators by letter that the firm was withdrawing as counsel from a bond offering due to possible violations of U.S. securities laws.[123] In the five weeks following the noisy withdrawal, reporters discovered that unconventional loans were made to TV Azteca's CEO[124] and the CEO had a financial interest in a transaction with a cell phone service provider.[125] These discoveries have led to a shareholder class action lawsuit.[126] Since the withdrawal, TV Azteca stock has plummeted.[127]

For the lawyers, this was a very risky choice. TV Azteca has retained counsel to sue Akin Gump Strauss Hauer & Feld for breaching client confidences.[128] In addition, it remains to be seen whether the firm or its lawyers will be subject to disciplinary action by the New York State Bar Association. In this case, due to the rules of the New York Bar Association, it is unlikely that Akin Gump Strauss Hauer & Feld will be sanctioned.[129]

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[121] 17 C.F.R. § 205 (2003).

[122] Patrick McGeehan, *Lawyers Take Suspicions on TV Azteca to Its Board*, N.Y. TIMES, Dec. 24, 2004, at Bus. 1.

[123] *Id.*

[124] Anthon Harrup, *TV Azteca Says Committee To Review Debt Disclosure Row*, DOW JONES INT'L NEWS, Jan. 7, 2004; Bloomberg News, *Mexican TV Executive Under Investigation*, N.Y. TIMES, Jan. 13, 2004.

[125] *Sweetheart Cup to be Sold*, WASH. POST, Dec. 25, 2003, at E02.

[126] *See, e.g.*, John Hecht & Marla Matzer Rose, *Unhappy New Year for TV Azteca: Shares Plunge Over Chief's Involvement in Controversial Debt Deal*, HOLLYWOOD REP., Jan. 12, 2004; *Bondholders File Lawsuit Against Mexico's Iusacell*, DOW JONES EMERGING MARKETS REP., Jan. 14, 2004; John Authers, *Lawsuit Blow for TV Azteca*, FIN. TIMES, Jan. 27, 2004, at 24.

[127] *See, e.g., Mexico's TV Azteca Shares Dive On News Of Disclosure Row*, DOW JONES INT'L NEWS, Dec. 24, 2003. *TV Azteca Stock Falls 9% on Allegations*, WALL ST. J., Dec. 26, 2003, at C9; *AT&T Freezes Managers' Salaries in '04*, ORLANDO SENTINEL, Dec. 27, 2003, at C3; Patrick McGeehan, *Citing Inquiry at TV Azteca, 3 Firms Tell Investors to Sell*, N.Y. TIMES, Jan. 9, 2004, at C6.

[128] *TV Azteca Hires Counsel*, BLOOMBERG NEWS, Jan. 8, 2004.

[129] N.Y. Code of Prof'l Resp. (NY CPR) § 4-101(C) (2002). The "other law" language of NY CPR 4-101(C)(2) should allow the SEC rules derived from the Sarbanes-Oxley Act to override confidentiality.

When states' disclosure rules conflict with the new SEC disclosure rules, lawyers are caught in a no man's land between disbarment and federal charges. This is a particularly threatening place to be due to the SECs aggressive enforcement stance. The SEC's hardball tactics with state bar associations only exacerbates this conflict. U.S. lawyers need the state bar associations and the SEC to cooperate and clarify the exact duties they owe to their clients. The SEC and the state bar associations can look to Hong Kong for an example of such cooperation.

III. HONG KONG ATTEMPTS TO CURE CORPORATE GOVERNANCE ISSUES THROUGH THE MEMORANDUM OF UNDERSTANDING AND THE STANDING COMMITTEE ON COMPANY LAW REFORMS REPORTS

Hong Kong recognized years ago that solicitors are uniquely situated in cases of corporate fraud and acted upon this belief long before the United States.[130] The MOU between the Law Society and the Hong Kong Stock Exchange is not only an excellent example of two regulatory powers working together for mutual benefit, but it also provides clear guidance as to a solicitor's duties when practicing before the stock exchange.[131]

Even with the MOU, Hong Kong still suffered recent corporate scandals.[132] Similar to the Sarbanes-Oxley Act, Hong Kong's Standing Committee on Company Law Reform ("SCCLR") was tasked with proposing new regulations to improve corporate governance in Hong Kong. The SCCLR released Phase I of its report and proposed regulations in July 2001.[133] Phase II was released in January 2004.[134]

Unfortunately, both of Hong Kong's attempted reforms are falling short. The MOU has never been used in a disciplinary case.[135] The Law

The NY CPR was last updated post-Sarbanes-Oxley effective Jan. 1, 2002. *Id.* Therefore it is likely that the NY Bar anticipated lawyers complying with Sarbanes-Oxley when the NY CPR was last updated and will likely not pursue disciplinary action against these lawyers. Regardless of the change to the NY CPR, the N.Y. State Bar Association's Business Law Section wrote an open letter to the SEC speaking against noisy withdrawal, saying that silent withdrawal should be sufficient. Letter from N.Y. State Bar Ass'n Bus. L. Sec., to the SEC (Dec. 18, 2002), *available at* http://www.nysba.org/Content/ContentGroups/News1/Release_attachments/businesslawcomments121802.pdf (last visited Jan. 14, 2005). The N.Y. State Bar Association Corporate Counsel Section wrote a supporting letter. Letter from N.Y. State Bar Ass'n Corp. Couns. Sec., to the SEC (Dec. 18, 2002), *available at* http://www.nysba.org/Content/ContentGroups/News1/Release_attachments/reedletter121802.pdf (last visited Jan. 14, 2005).

[130] The MOU was effective in 1996. *See* MOU, *supra* note 15.

[131] *Id.*

[132] *See, e.g.*, *Governance Offers Poor View*, *supra* note 6; *Dishonored Dealmaker*, *supra* note 7.

[133] *See* PHASE I, *supra* note 18.

[134] *See* SCCLR, *supra* note 17.

[135] *See From the Council Table I*, *supra* note 22.

Society rules regulating solicitors do not clearly define who the client is when the solicitor is representing a corporation.[136] The SCCLR Phase I changes have met with limited success and the Phase II changes, while it is too soon to measure any effect, do not go far enough.

A. The Law Society of Hong Kong and the Hong Kong Stock Exchange Negotiated the Memorandum of Understanding

Solicitors are self-regulated through the Law Society of Hong Kong[137] ("Law Society"). Established in 1907, the Law Society is comparable to U.S. state bar associations.[138] It is a professional society, a community-relations organization, a political lobby, and a regulatory body.[139] The Law Society maintains the Guide to Professional Conduct ("GPC"),[140] which is the Hong Kong counterpart to a state's rules of professional conduct.

Unlike the United States, the Law Society and the Hong Kong Stock Exchange had the foresight to realize that solicitors would be involved in corporate securities law violations. This led them to collaborate on a Memorandum of Understanding Between the Law Society of Hong Kong and the Stock Exchange of Hong Kong in 1996.[141] The Law Society incorporated the MOU directly into the GPC as Title 15, giving the rules in the MOU the same power as any rule regulating solicitors.[142]

In the MOU, the Hong Kong Stock Exchange agrees not to make rules regulating, state any public findings about, impose any penalties or sanctions on, or take any other kind of disciplinary action against a solicitor unless the solicitor violates one of the following three rules:

> (1) If a solicitor makes an untrue representation to the Exchange: made on the instructions of his client, and purporting to be so made, and which the solicitor knows to be untrue or made with reckless disregard as to its truthfulness; or made otherwise than on instructions of a client by the solicitor

[136] There is no rule in the professional guide comparable to Model Rule 1.13. HONG KONG SOLICITOR, GUIDE TO PROF'L CONDUCT, *available at* http://www.hklawsoc.org.hk/pub_e/professionalguide/ (last visited Jan. 14, 2005).
[137] LAW SOCIETY OF HONG KONG, ABOUT THE LAW SOCIETY: PROFILE (2002), *at* http://www.hklawsoc.org.hk/pub_e/about/ (last visited Jan. 14, 2005).
[138] *Id.*
[139] *See* Video: "The Law Society of Hong Kong," *available at* http://www.hklawsoc.org.hk/pub_e/about/vcd/Chinese_English_128K.WMV (last visited Jan. 14, 2005).
[140] HONG KONG LAW SOCIETY, HONG KONG SOLICITER'S GUIDE TO PROFESSIONAL CONDUCT, *available at* http://www.hklawsoc.org.hk/pub_e/professionalguide/ (last visited Jan. 14, 2005).
[141] *See* MOU, *supra* note 15.
[142] *Id.*

knowing it to be untrue or without having made reasonable inquiries as to its truthfulness.

(2) Where a solicitor knowingly or recklessly facilitates or participates in a breach of the Listing Rules.[143]

(3) Where acting for a client in relation to a listing matter, a solicitor knowingly or unreasonably fails to advise his client in relation to relevant requirements of the Listing Rules, or incorrectly advises his client in relation to such requirements, knowing such advice to be incorrect or with reckless disregard as to its correctness.[144]

All other disciplinary actions are reserved solely to the Law Society.[145]

The MOU also sets a clear pecking order for the rules. If a solicitor refuses to answer questions on these three actions as part of a Hong Kong Stock Exchange investigation by claiming it violates another Law Society GPC rule, then the Stock Exchange refers the matter to the Law Society to resolve.[146] There is nothing in the MOU that directs a solicitor to disclose any confidential information.[147] This is important to solicitors, as it sets a clear hierarchy of rules and definition of their duties, unlike the conflicts and confusion experienced by U.S. lawyers.

B. *SCCLR Phase I and Phase II Reports Propose Reforms to Hong Kong Company Law*

After an intense review of Hong Kong laws, the SCCLR released its final recommendations in the Phase II Government Corporation Governance Review, which included the Committee's recommended changes to Hong Kong's securities regulations.[148] Phase I was released three years earlier.[149] Both Phase Reports cite in their terms that the reports were instigated by

[143] The MOU gives further clarification on this point in an internal note acknowledging that "'[k]nowingly participat[ing]' in a breach is a wide concept but see below the Exchange's express recognition of certain examples where a solicitor will not be deemed to have acted improperly." *Id.*

[144] *Id.*

[145] *Id.*

[146] *Id.*

[147] *Id.* Hong Kong solicitor's duty of confidentiality is defined in Guide to Professional Conduct, Chapter 8: Confidentiality, *available at* http://www.hklawsoc.org.hk/pub_e/professionalguide/ch08/ (last visited Jan. 14, 2005).

[148] *See* PHASE II REPORT, *supra* note 18. *See also* Press Release, SCCLR, SCCLR Issues Final Recommendations from Corporate Governance Review Phase II (Jan, 20, 2004), *available at* http://www.info.gov.hk/gia/general/200401/20/0120144.htm (last visited Jan. 14, 2005).

[149] *See* PHASE I REPORT, *supra* note 18. *See also* Press Release, SCCLR, SCCLR: Consultation on Corporate Governance Review Phase I Proposals (July 20, 2001), *available at* http://www.fstb.gov.hk/fsb/ppr/press/doc/pr200701_e.doc (last visited Jan. 14, 2005).

Hong Kong's need to rein in the inequitable powers held by majority shareholders and increase minority shareholder protections.[150] Phase II also recognizes the need to reduce corporate scandals.[151] Both Phase Reports address similar issues and come up with many similar solutions as Sarbanes-Oxley, including greater duties for directors,[152] officers,[153] and auditors,[154] as well as increasing the rights of shareholders in private actions,[155] which are very limited in Hong Kong.[156] However, neither Phase Report addresses regulating solicitors. The SCCLR report is poised to try to stop corporate fraud at the beginning by affecting a director's duties, or to catch it after the fact by regulating the accountants and auditors, but it is missing the key piece—catching fraud as it happens—which solicitors are in a unique position to do.

C. *The MOU, the Guide for Professional Conduct, and the SCCLR Phase I and II Reports Need To Be More Effective*

These three sets of rules have not been effective in combating corporate scandals. The MOU, for all its cooperative elegance and clarity, has never been used.[157] The Law Society is in the process of renegotiating the MOU in light of changes to the Securities and Futures Ordinance, but the Law Society does not want to alter the original MOU.[158] The GPC does not clearly define who the client is when the solicitor has a conflict of interest between an officer or owner of a corporation and the corporate entity itself. The SCCLR Phase I amendments have not been effective,[159] and the Phase II recommendations do not go far enough to protect shareholders.

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150 PHASE I REPORT, *supra* note 18, at iii; PHASE II REPORT, *supra* note 18, at iii.

151 *See* PHASE II REPORT, *supra* note 18.

152 *Id.* at 15-20, 70-81.

153 *Id.* at 32-40.

154 *Id.* at 40-45, 126-139.

155 *Id.* at 83-96. Both Phase I and II reports stated that this was one of the main impediments to having active minority shareholders, something very desirable, because through litigation the companies are kept honest. *Id.*; PHASE I REPORT, *supra* note 18, at 52-60.

156 *See The Expropriation Game*, *supra* note 23.

157 *See* MOU, *supra* note 15.

158 *From the Council Table: Memorandum of Understanding with the Stock Exchange*, H.K. LAW., July 2004, *available at* http://www.hk-lawyer.com/2004-8/Default.htm (last visited Jan. 14, 2005) [hereinafter *From the Council Table II*].

159 Paul Spink & Stephen Chan, *The Hong Kong Company Director's Duty of Skill and Care*, 33 H.K. L. J. 139 (2003) [hereinafter *HK Director's Duty*].

1. The MOU Has Never Been Used

Under the MOU, the Hong Kong Stock Exchange does not regulate solicitors in the same way as the SEC is now trying to regulate lawyers. The problem remains, however, that the MOU has not stopped solicitors from aiding corporations in defrauding their minority shareholders, looting the company resources, or other acts of corporate malfeasance.[160] In the eight years of its existence, the MOU has never been used in a disciplinary proceeding.[161] The Law Society is currently in the process of revising the MOU,[162] especially in light of the transfer of some securities enforcement powers from the Hong Kong Stock Exchange to the Securities and Futures Commission during the 2005 calendar year.[163]

The current MOU is an excellent example of cooperation of regulatory agencies. Unfortunately, it also further limits the Hong Kong Stock Exchange's weak enforcement powers and prevents Hong Kong from turning to a noisy withdrawal system similar to that of the SEC. The Law Society needs to undertake the major step of clearly defining the client, so that solicitors can help protect the markets from corporate governance abuses.

2. The Professional Guidelines Do Not Define the Corporate Entity as the Client

Hong Kong solicitors lack one of the most useful tools U.S. lawyers have to protect themselves when representing corporations: Model Rule 1.13, which defines the corporate entity as the client, not the individual officers and executives.[164] While the GPC admonishes the solicitor to be wary of dual roles and conflicts of interest when sitting on boards of directors for corporations,[165] the GPC has no rule about an organization as a client. This is a crucial shortcoming in the GPC. Solicitors may often have a conflict of interest between the corporation they represent and the officers or directors who secured their services. This conflict is heightened in cases where the company is family-owned or closely-held, which is true for the

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[160] *See From the Council Table I*, *supra* note 22.
[161] *Id.*
[162] *Id.*
[163] Joel Baglole, *Risk Central: Hong Kong's Market Regulation Remains Lax*, WALL ST. J., Apr. 9, 2004, at C1 [hereinafter *Risk Central*].
[164] MODEL RULE OF PROF'L CONDUCT R. 1.13 (2003).
[165] GUIDELINES FOR PROF'L CONDUCT §7.01 (Conflict of Interest Between Solicitor and Client) cmt. 6.

majority of Hong Kong companies.[166] The lack of legal protections for minority shareholders and the growing number of retail investors in Hong Kong are also bringing this problem into sharp focus.[167]

a. Solicitors Have a Conflict of Interest Between the Owners or Officers and the Corporation for Hong Kong's Mainly Family-Owned or Closely-Held Corporations

Like all Asian markets, Hong Kong has had ongoing problems with corporate controls and governance due to the family-owned and closely-held nature of many of its corporations.[168] The resulting lenient internal controls led to numerous mini-Enron collapses.[169] The lack of controls also harmed investor confidences in investing in Asia,[170] which in turn negatively effected Asian economies and slowed down the recovery from the recession that began in 1997.[171] U.S. institutional investors are already turning down opportunities in Asia due to the lack of corporate controls on family-owned businesses.[172] Hong Kong is especially vulnerable to corruption because of the opening of new markets in China,[173] the ownership and makeup of the Hong Kong Stock Exchange,[174] and the current state of corporate governance regulations, remedies, and punishments.[175] Solicitors in Hong Kong need a rule similar to Model Rule 1.13 to allow them to differentiate between representing the corporation and representing the controlling family members.

b. Hong Kong Has Minimal Protections for the Growing Numbers of Minority Shareholders

Hong Kong's dearth of protections for the growing number of minority shareholders compounds the problems that result from closely-held

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166 *See The Expropriation Game*, *supra* note 23.

167 *See* Part III.C.2.b *infra*.

168 Chang Q. Sun, *Capital Demands: A Warning for Asia's Family Companies*, ASIAN WALL ST. J., Mar. 1, 2002, at A9.

169 Sara Webb, *Enron Redux: Warning Signs May Signal the Next Collapse*, ASIAN WALL ST. J., Mar. 7, 2002, at M1; *The Expropriation Game*, *supra* note 23, at 78-80.

170 Chang Q. Sun, *supra* note 168.

171 Joseph W. Dellapenna, *Does Rule of Law Matter in the Hong Kong Special Administrative Region?*, *in* CHINA AND HONG KONG IN LEGAL TRANSITION, 91, 93 (Joseph W. Dellapenna & Patrick M. Norton eds., 2000).

172 *Id.*

173 Loretta Ng & Ruby Chan, *China-Related IPOs Meet Growing Demand—Record Offering for 2003 Puts Hong Kong at Center of a Boom in New Issues*, ASIAN WALL ST. J., Dec. 8, 2003, at M2.

174 HONG KONG SECURITIES AND EXCHANGE COMMISSION, ABOUT HKEX, *at* http://www.hkex.com.hk/exchange/asso/exchange.htm (last visited Jan. 14, 2005).

175 *Risk Central*, *supra* note 163.

and family-owned corporations cheating retail investors and creating more conflicts for solicitors. Both the Hong Kong Securities and Futures Commission ("SFC")[176] and corporations are anxious to lure in a diverse investment base, but, once shareholders buy their stock, the minority shareholders have very limited rights.[177]

When Hong Kong's typical family-owned corporations[178] need to gain additional capital, the family takes the company "public" by floating twenty five percent of the shares on the Hong Kong Stock Exchange.[179] This never allows the investor shareholders to gain either a controlling interest or even enough votes to place a member on the board, let alone affect major change in relation to an expropriation, merger, or acquisition.[180] Investors who buy shares in non-listed companies actually fare a bit better because they can fall back on Companies Ordinance 168A,[181] which allows shareholders recourse to the courts if the company's operation has been unfairly prejudicial to the minority shareholder's interests.[182]

Just prior to the transfer of Hong Kong sovereignty from Britain to China, the SFC implemented an interim order regulating initial public offers that effectively mandated the entry of a greater number of minority shareholders into the market.[183] The goals of the interim order were to limit purchases of the entire initial public offer by single individuals or entities, as well as to diversify the investment base and to slow down the rate of initial public offers.[184] The interim order stipulated that half of the shares of an initial public offers must be reserved for investors who are investing less than $5 million dollars.[185] This interim law is still in place and Hong Kong continues to have a significant and growing number of minority investors.[186]

While the number of minority shareholders is rising, they still lack the right to privately sue in securities cases or to instigate class action

[176] The SEC and the SFC hold analogous positions in the U.S. and Hong Kong markets.

[177] *The Expropriation Game*, *supra* note 23.

[178] *See* A. Majid, Low Chee Keong, & K. Arujnan, *Company Directors' Perceptions of their Responsibilities and Duties: A Hong Kong Survey*, 28 H.K. L. J. 60 (1998).

[179] Companies Ordinance, § 42 (1997).

[180] *The Expropriation Game*, *supra* note 23.

[181] Companies Ordinance, § 168A (1997).

[182] *Id.* See *The Expropriation Game*, *supra* note 23, at 87, for a discussion of what meager benefits these expanded rights include.

[183] Erik Guyot, *Hong Kong Seeks to Stem Funds Pouring Into IPOs*, WALL ST. J., May 23, 1997, at A9B.

[184] *Id.*

[185] *Id.*

[186] *Economist Intelligence Unit—Executive Briefing*, ECONOMIST INTELLIGENCE UNIT LTD. 310, Apr. 16, 2004.

lawsuits.[187] One of the main protections offered to U.S. minority shareholders is the ability to initiate a lawsuit for private damages on behalf of a shareholder, as well as filing class action lawsuits for all damaged shareholders.[188] This protection does not exist in the Hong Kong markets.[189] The Akai Holdings bankruptcy offers a perfect example of why this distinction between investor protections is important.[190] Hong Kong shareholders and creditors are still without recourse for the hundreds of millions of dollars that disappeared. Hong Kong creditors call the case "Hong Kong's Enron."[191] The Singer Sewing Machine Co., a U.S. company that Akai purchased and revived, has safely emerged from bankruptcy court as a going concern.[192] The U.S. Singer Sewing Machine bondholders have been able to file suit against Akai CEO James Ting, his former U.S. accountants, and his former U.S. bankers in an attempt to recover their losses.[193]

Hong Kong's minority shareholders are further limited by unfair company rules, such as the rules allowing hand votes at annual shareholder meetings and by severe limitations on proxy voting.[194] David M. Webb, retired Corporate Finance Director of BZW Asia Limited and member of the Shareholders' Sub-committee of the SCCLR,[195] publishes a "Practitioner's Guide to Listing Rules Loopholes," which informs minority shareholders of the most popular ways in which family-owned Hong Kong corporations will try to discount their votes.[196] A current and long-standing practice is for controlling directors to grant one or two shares to hundreds of employees and require them to attend the annual meeting.[197] When votes come up, the sea of employee hands voting the way their bosses required them to vote overwhelms the legitimate minority shareholders' votes.[198]

Mr. Webb also cautions against other common dishonest practices. Some boards delay reporting of company news to extend the one-month

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[187] *The Expropriation Game*, *supra* note 23, at 93-97.
[188] *Id.*
[189] Securities and Futures Ordinance, § 22 (2003) (a corporate director's immunity from civil lawsuits).
[190] *See infra* Part III.E.
[191] *Dishonored Dealmaker*, *supra* note 7.
[192] *Id.*
[193] *Id.*
[194] Hong Kong Stock Exchange, Main Listing Board Rules 13.39.
[195] Mr. Webb's full credentials are available at http://www.webb-site.com/aboutus.htm#bio (last visited Jan. 14, 2005).
[196] David M. Webb, *The Practitioner's Guide to Listing Rules Loopholes*, *at* http://www.webb-site.com/loopholes.htm (last visited Jan. 14, 2005).
[197] *Id.*
[198] *Id.*

insider trading blackout to facilitate directors' insider-trading.[199] Another trick is to set a five-day count-back for stock options pricing. This allows directors to grant themselves options immediately after a major announcement priced at the stock value five days prior to the announcement.[200] Designating the controlling shareholder of a company as a discretionary trust is yet another way directors get around the rules prohibiting connected persons and interested parties from being involved in any mergers or transactions.[201] The true size of the company or the stock pool is rarely published, so minority investors may never know the true value of their holdings.[202] Finally, as the company must only notify the SFC and not the public regarding the resignation or firing of auditors or company secretaries, the board may choose not to notify shareholders of major auditor and accountant staff changes, key indicators of ongoing corporate fraud.[203]

c. *The Incorporation of the Hong Kong Stock Exchange and the Enforcement Strategy of the Hong Kong Securities and Futures Commission Contribute to Solicitors' Woes*

The Hong Kong Stock Exchange, unlike other traditional independent exchanges, is a for-profit corporation that is listed on its own exchange.[204] Hong Kong's listing rules are much more flexible and less restrained than those of its U.S. and British counterparts, and Hong Kong investors do not have the ability to seek class-action recourse from the courts.[205] Unlike the SEC, the SFC does not investigate companies after public offerings to verify the accuracy of the company's financials.[206] The SFC focuses on auditing and reviews the filings provided by the company before they are issued to the public.[207] This enforcement stance does not adequately protect investors,

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[199] *Id.*

[200] *Id.*

[201] *Id.*

[202] "So after a placing has been announced, you will not know when it is completed. If it is a 'best efforts' placing, you won't know how many shares are finally issued. When employees exercise their share options, you will not know. When shares are issued as deferred consideration under a previously announced transaction, you won't know." David M. Webb, *The Practitioner's Guide to Listing Rules Loopholes, at* http://www.webb-site.com/loopholes.htm (last visited Jan. 14, 2005).

[203] *Id.*

[204] *Id.* Corporate information for investors in the Hong Kong Stock Exchange corporation is available at http://www.hkex.com.hk/relation/relation.htm (last visited Jan. 14, 2005).

[205] *Risk Central, supra* note 163.

[206] *Securities and Futures Commission of Hong Kong: Whom and How We Regulate, supra* note 25.

[207] Hong Kong Securities and Futures Commission, *A Consultation Paper on the Securities and Futures (Stock Market Listing) Rules and the Securities and Futures (Transfer of Functions - Stock Exchange Company) Order* (2002), *available at* http://eapp01.sfc.hk/apps/cf/stockmarketlistingrules.nsf/eng/Download/1/$FILE/stock_mkt_listing_consult_eng.pdf (last visited Jan. 14, 2005).

allows solicitors and companies to more easily offer inaccurate reports, and drains resources from the prosecution and investigation offices.[208] Finally, while the SFC can publicly sanction corporations and in extreme cases delist them, it cannot instigate criminal proceedings against corporations or levy sizable fines.[209]

3. *SCCLR Phase I Did Not Solve the Problems and Phase II Does Not Go Far Enough*

The SCCLR recommendations will strengthen Hong Kong's markets, but both reports could have presented much stronger solutions. Both phases of the SCCLR reports are being used to diligently close loopholes in Hong Kong's Companies Ordinance, Main Board Listing Rules,[210] and Securities and Futures Ordinance, including eliminating a case-law-based virtual indemnification of incompetent board members[211] and adding much needed auditing and director controls.[212] The reports also helped with the much-needed consolidation of the Securities and Futures Ordinance.[213] However, neither Phase Report even mentions regulating solicitors, although solicitors are involved in every aspect of the actions regulated by the affected ordinances, listings on the main board, and major transactions.

One of the SCCLR Phase II Report's biggest victories for minority shareholders was to allow proxy voting at the Annual General meetings,[214] though voting by a show of hands is still allowed[215] which undercuts this victory. The other Phase II victory was extending civil rights to shareholders and the acknowledgement that Hong Kong should move toward allowing class action derivative shareholder suits, though the SCCLR does not

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[208] *The Expropriation Game*, *supra* note 23.

[209] *Id.*

[210] The Main Board Listing Rules adopted many of the SCCLR Phase II recommendations on March 31, 2004. Memorandum from Richard Williams, Head of Listing, Hong Kong Stock Exchange, to Subscribers, Update No. 80: Amendments to the Listing Rules Relating to Corporate Governance Issues, Initial Listing Criteria and Continuing Listing Obligations (Mar. 31, 2004), *available at* http://www.hkex.com.hk/rule/mbrule/mb_rupdate_cover.htm (last visited Jan. 14, 2005).

[211] *See HK Director's Duty*, *supra* note 159. Prior to the SCCLR Phase II Report a director was held to the standard of the director's own experience and qualifications, or "an idiot was held to the standard of being an idiot." *Id.* at 143. The SCCLR Phase II report increased this standard to include the skill and diligence generally associated with the position and included a recommendation for tracking corporate director training programs. PHASE II REPORT, *supra* note 18, §§ 3.1, 3.9.1.

[212] *See, generally HK Director's Duty*, *supra* note 159.

[213] Say H. Goo, *Corporate Dimensions of the Securities and Futures Ordinance*, 33 H.K. L. J. 271, 271 (2003).

[214] PHASE II REPORT, *supra* note 18, §4.5.1, at xxi.

[215] *Id.*

recommend the immediate adoption of this change.[216] The SCCLR reports are important steps to curing the deficiencies in the Hong Kong markets for minority investors. As the SCCLR is, indeed, a standing committee, further recommendations may make the Hong Kong markets even safer.

D. *Case Study: BOTO*

The impact of the lack of control over family owned or closely-held corporations is highlighted by Boto, Inc.[217] Boto sold off its successful artificial Christmas tree and patio furniture division[218] to a company partially owned by Boto CEO Michael Kao Cheung-Chong.[219] The price of the sale was a bargain for the purchasing company.[220] This sale was made to fund Boto's experimental computer graphics unit.[221] As it turned out, the computer graphics division was acquired to personally benefit another board member.[222] Another reason for the sale of the Christmas tree division was to move a profitable division to a non-public company that solely benefited Boto's majority owners.[223] Minority shareholders appealed to the SFC to investigate or stop the sale.[224] In an unprecedented move, Andrew Sheng, Chairman of the SFC, released an open letter to investors.[225] The letter informed the investors that the Commission would not step in to protect their investment and suggested that, if they were displeased with the way Boto was being run, they should sell their stock.[226] After the full details of the Boto transactions came to light, Mr. Sheng retracted his earlier statement and acknowledged that some regulatory intervention into questionable transactions would have been appropriate.[227]

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[216] *Id.* at 106.

[217] *See Governance Offers Poor View*, *supra* note 6.

[218] Samuel Yeung, *Santa Gift-Wraps Tree Maker*, S. CHINA MORNING POST, Aug. 20, 2002, at Bus. 2.

[219] Samuel Yeung, *Boto Challenges Bans on Voting*, S. CHINA MORNING POST, May 9, 2002, at 3.

[220] Samuel Yeung, *Boto Pushes on with Controversial Sale*, S. CHINA MORNING POST, May 31, 2002, at 2.

[221] *Id.*

[222] Samuel Yeung, *Boto Failed to Disclose Connected Transactions*, S. CHINA MORNING POST, July 19, 2002, at 2.

[223] *The Expropriation Game*, *supra* note 23, at 80-81.

[224] Enoch Yiu, *SFC Rejects Intervention Role in Firms: In Spite of Complaints, Sheng Puts Onus on Investors*, S. CHINA MORNING POST, May 14, 2002, at 1.

[225] *Id.*; Samuel Yeung, *HKEx Replies on Boto Vote Give Rise to More Questions*, S. CHINA MORNING POST, Aug. 30, 2002, at Bus. 12.

[226] Yiu, *supra* note 224; Yeung, *supra* note 225.

[227] Samuel Yeung, *Securities Watchdog Chief Says Middle Ground Exists in Role of Regulators on Management Issues: Sheng Changes Governance Tone*, S. CHINA MORNING POST, Sept. 24, 2002, at 3; Samuel Yeung, *Boto Sale Ignores Advice*, S. CHINA MORNING POST, Aug. 20, 2002, at Bus. 1.

E. *Case Study: Akai Industries*

Akai Holdings Ltd. demonstrates Hong Kong's problems with internal controls on closely-held corporations and the shareholder's lack of civil recourse.[228] In 1982, Akai CEO James Ting started with a small electronics firm and built it into a multi-national empire by buying well-known brands that were in financial trouble and reinvigorating them.[229] Akai Holdings revived stocks as diverse as Singer (sewing machines), Sansui (electronics), and Hang Ten (fashion).[230] At its peak it sold $ 1.4 billion in merchandise per year.[231] Akai held more than $2 billion in assets.[232] In January 1999, the company had $262 million in cash and $1 billion in shareholder equity.[233] In the summer of 2000, Mr. Ting transferred management control to a holding company, liquidated many personal and corporate assets without stockholder approval, and disappeared, probably into mainland China.[234] The resulting investigation uncovered a corporation with few internal controls on spending, allowing Mr. Ting to use corporate accounts as his personal petty cash.[235] Non-existent assets, which were used to secure hundreds of millions of dollars in debts, were shuffled and lost through various accounts in countries such as the British Virgin Islands, Liberia, and Jordan.[236] Investors in Hong Kong are still waiting for a criminal prosecution, which will be worthless when it happens because no one can find Ting.[237] While Hong Kong investors have no real recourse, bondholders in the United States are able to attach Akai's U.S. assets and will probably be made whole again.[238]

IV. THE UNITED STATES AND HONG KONG EACH HAVE PART OF A SOLUTION FOR EFFECTIVE USE OF LAWYERS TO AID IN CORPORATE GOVERNANCE REFORM

Both the U.S. and Hong Kong systems have strong and weak points, in nearly mirrored opposition. The two countries should learn from each other. The SEC should negotiate more with the state bar associations, not just to relieve the tensions and stave off the inevitable lawsuits, but to come

228 Jane Moir, *Corpse Stripped to Bones*, S. CHINA MORNING POST, June 20, 2001, at 1.
229 *Id.*
230 *Id.*
231 *Dishonored Dealmaker*, *supra* note 7.
232 *Id.*
233 *Corpse Stripped to Bones*, *supra* note 228.
234 *Id.*
235 *Id.*
236 *Id.*
237 *Dishonored Dealmaker*, *supra* note 7.
238 *Id.*

up with a clear definition of a lawyer's duties when representing a listed corporation. Hong Kong needs to step up the tenor and timing of its enforcement practices for both securities violations by companies and for solicitors violating the MOU. Hong Kong also needs to clearly differentiate the corporate entity as the client, so lawyers will be able to help public companies resist the tactics of majority controlling shareholders.

A. *In the United States, the SEC Should Negotiate with Bar Associations and Companies to Ease Tensions and Increase Clarity of a Lawyer's Duties*

Hong Kong's approach of negotiation and clarification would help the current situation in the United States. The SEC should be more willing to negotiate with bar associations and companies. If the SEC wants companies to cooperate, it should back down from demanding cooperation, skyrocketing penalties, and its aggressive prosecution stance. While on the one hand the SEC lauds cooperation by firms such as HomeStore, it should realize that the rising penalties and strong-arm enforcement methods will discourage companies, auditors, officers, and attorneys from cooperating in all but the most extreme criminal cases.

The ongoing battles between the state bar associations as well as the SEC's firm take-no-prisoners stance on what is a contentious federalism issue only worsens the confusion about and resistance to the new rules. U.S. lawyers should consider the benefits of a negotiated compliance, such as the MOU. While there has not been a case under the MOU, its preeminence in the rules of conduct would put lawyers on notice of their duties both to the integrity of the market and to the ethical standards of the Law Society.

The SEC negotiating with the state bar associations would not only reduce tension, but also result in a clear definition of the lawyer's duties to the client, the state rules, and the SEC. This clarity would allow lawyers to better represent their clients and to protect themselves from malpractice lawsuits, ethics complaints, and SEC sanctions.

The MOU may have helped in the Enron case, both to discover and curb the fraud earlier and to give the SEC another avenue to increase the victim's fund[239] by allowing the SEC to pursue the lawyers. Enron involved breaches of accounting standards and corporate governance controls.[240] The

[239] Another feature of Sarbanes-Oxley is that SEC penalties and disgorgements no longer go to the United States Treasury; they go to a "Fair Fund" to be used to rectify and mitigate victim's damages. 17 CFR §§ 201.1100-1106.

[240] Robert B. Thompson, *Corporate Governance After Enron*, 40 HOUS. L. REV. 99, 111 (2003); William W. Bratton, *Enron and the Dark Side of Shareholder Value*, 76 TUL. L. REV. 1275, 1299 (2002).

lawyers may not have knowingly or recklessly participated in the violations, but discovered afterwards that their services were used in furtherance of perpetrating frauds on the market.[241] Because the MOU does not allow for this hindsight correction, the SEC should maintain the reflective portions of the Sarbanes-Oxley-derived regulations.

B. Hong Kong Should Scale Up Enforcements and Clarify the Relationship Between the Solicitor and the Corporation

Hong Kong needs to increase the tenor and timing of enforcement of its securities regulations. For solicitors, the laws are in place and just need to be used. The threat of a noisy withdrawal is also needed to give the solicitor power in negotiating with the client. The Hong Kong Law Society should consider adopting a new GPC similar to Model Rule 1.13 (Organization as a Client). This allows lawyers to represent the listed corporation, not the majority owners.

There are three levels of enforcement involved, all of which need to be strengthened or pursued more aggressively by regulators in Hong Kong. First of all, on the client-level, the solicitor should be able to noisily withdraw. This process would give the solicitors the power to keep a company's directors and owners honest while giving early warning to investors to do their own research into the company. In the Akai bankruptcy, a lawyer responsible for moving assets would possibly have seen well in advance of the bankruptcy that the emperor had no clothes—there were no assets supporting the financing arrangements. A noisy withdrawal could have alerted the authorities before the money, and Mr. Ting, vanished.

In the TV Azteca case, the most Akin Gump Strauss Hauer & Feld would have been able to do under the GPC, even including the MOU, was silently withdraw, choosing to neither knowingly nor recklessly participate in a Hong Kong Stock Exchange violation. There is no affirmative duty to inform the Hong Kong Stock Exchange, nor a process to inform the exchange, aside from telling the truth in a tribunal.[242] Neither the investors nor the corporation would have been protected from the fraudulent self-interested actions of the TV Azteca CEO. A less scrupulous or less thorough firm would not be prevented from completing the transaction. The regulatory agency would have no idea of the fraud taking place. The

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[241] Susan P. Koniak, *When the Hurlyburly's Done: The Bar's Struggle with the SEC*, 103 COLUM. L. REV. 1236, 1239 (2003).

[242] *See* MOU, *supra* note 15.

corporation's alleged violations would continue; and the shareholders would still be damaged.

The second enforcement level needing improvement is the Law Society. It is doubtful that during the years the MOU has been in place not a single violation of its provisions has occurred, yet the MOU has never been used in a single prosecution. The Law Society needs to more aggressively pursue these violations. When solicitors see that their ability to practice is on the line, they may be more inspired to stand up to corporate officers.

The final level of enforcement improvement is at the SFC and Hong Kong Stock Exchange. These organizations should switch their focus from pre-release auditing to verifying posted corporate information. Regardless of whether the switch is made, the SFC needs to take the new recommendations of the SCCLR and actively pursue violators. As seen in the HomeStore case, fear can work.[243] If, like HomeStore, the errant company knows that the regulatory agency will come down swiftly and severely on any infraction, then companies, as HomeStore did, will strive to remain in compliance with regulations.[244]

The MOU also contains no differentiation between the duty to the organization as a client, as opposed to the directors and officers. Again, this is a key to protecting Hong Kong companies from their majority owners. While the MOU is an impressive and far-sighted agreement, it still does not protect minority shareholders from the tyranny of the majority owners. Hong Kong Law Society should consider adopting Model Rule 1.13 (The Organization as a Client).[245] Adopting Model Rule 1.13 may have helped in the Boto case. A solicitor acting under a rule similar to Model Rule 1.13 may have raised red flags to the board and to the authorities about the CEO selling off the corporation's most successful division for well below market value in order to give more funding to a non-profitable division that was purchased from another interested board member. Here, as the highest officers were involved, reporting up would have been futile, but reporting out options would still be available to the solicitor.

C. *Hong Kong Should Make These Changes Slowly to Remain Competitive with Chinese Markets*

Adopting similar regulations to Sarbanes-Oxley may prevent Hong Kong from continuing to open up Chinese markets and giving investors

243 See comments by Sandra J. Harris, *supra* note 99.
244 *Id.*
245 MODEL RULES OF PROF'L CONDUCT R. 1.13 (2003).

access to Chinese corporations. The strict auditing and outside board member requirements may deter corporations from listing in Hong Kong, sending the new corporations to lesser-regulated markets, such as Shanghai.

Competition among East Asian markets is intense, but the East Asian market that Hong Kong should be most worried about, however, is mainland China. China and Chinese corporations are becoming savvier in the world markets, with or without the "gateway" the Chinese Central Government envisions Hong Kong providing.[246] The Initial Public Offering ("IPO") for China Telecom,[247] a previously government-owned utility, listed on both the Hong Kong and U.S. stock exchanges.[248] China Telecom is only the first of many state-owned companies being offered,[249] as investors looking to get into mainland China markets consider buying large state-run Chinese IPOs a safe option.[250] These mainland Chinese corporations can access "the huge pool of domestic savings by selling renminbi-shares,"[251] while companies incorporated in the Hong Kong Special Administrative Region must get permission to raise capital in mainland China.[252] China maintains greater control over companies operating in the mainland than in the Hong Kong Special Administrative Region, and therefore taxes the mainland and Hong Kong corporations differently to encourage mainland investment.[253] China's internal banks are preparing to sell shares of stock.[254] Mainland China is also actively pursuing corporate governance reforms in order to compete in attracting international investors.[255] Not only is Shanghai competing with Hong Kong to become the entryway to Chinese markets, but questionable

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[246] Dellapenna, *supra* note 171, at 93.

[247] Robert Bailhache, *SEC is Expected to Clear China Telecom's Initial Public Offering*, KNIGHT RIDDER TRIBUNE BUS. NEWS, Sept. 22, 2002.

[248] Craig Karmin, *Best Route to China May Be Indirect One: Many Turn to Asian Stocks With Mainland Exposure As Way to Invest in Economy*, WALL ST. J., Jan. 9, 2003, at C1. China Telecom recently announced a future second offering of shares. Loretta Ng, *China Telecom Plans to Offer New Shares—Move Would Help Finance Acquisition of 10 Networks; Net Profit Climbs Sharply*, ASIAN WALL ST. J., Mar. 18, 2004, at A3.

[249] Matt Pottinger, *IPO Shows China Is Bent on Selling State Enterprises*, WALL ST. J., Oct. 31, 2002, at A17.

[250] Craig Karmin, *China's Huge Market Is a Tricky Play for Investors—Many Turn to Asian Stocks With Mainland Exposure To Tap Surging Economy*, WALL ST. J. EUR., Jan. 10, 2003, at M1.

[251] *Id.* Renminbi is the Chinese currency. Renminbi, or RMB, means "People's Currency." CHINATOUR.COM, CHINESE CURRENCY—RENMINBI, http://www.chinatoday.com/fin/mon/ (last visited Jan. 14, 2005).

[252] *See Karmin, supra* note 250; Dellapenna, *supra* note 171, at 93.

[253] *See* Andrew Halkyard, *One Country, Two (Taxation) Systems*, 9 PAC. RIM L. & POL'Y J. 73 (2000).

[254] Keith Bradsher, *China Announces New Bailout of Big Banks*, N.Y. TIMES, Jan. 6, 2004, at c.1.

[255] Richard Daniel Ewing, *Corporate Governance Can Drive China's Reforms*, ASIAN WALL ST. J., Nov. 22, 2002, at A9.

Chinese companies are already using Hong Kong's international reputation and listing on the Hong Kong Stock Exchange, only to be sanctioned later.[256]

Hong Kong, therefore, needs to take slow steps toward regulation. Moving to a fully-regulated system quickly may hinder its competitiveness vis-à-vis other Asian markets, even while improving accountability to minority and international shareholders.

V. CONCLUSION

Lawyers and solicitors are in a unique position to detect and prevent corporate fraud. Both the U.S. and the Hong Kong systems appreciate this, but the two systems approach controlling lawyers and solicitors very differently. The United States strong-arms lawyers to comply with disclosure rules; Hong Kong negotiated a clear agreement between two enforcement entities. Both systems need to be strengthened in order to assure compliance, however, or both systems will continue to rely on the fallible adherence to the rules by lawyers and solicitors.

Lawyers and solicitors also must protect their client's secrets. This is inherent to any legal practice and should be respected, if not revered. Any disclosure of information should be highly selective, both in what is disclosed and to whom it is disclosed. However, to protect third party interests, this escape valve must be allowed. When the client has abused the attorney-client privilege and used the lawyer or solicitor to commit fraud, the lawyer or solicitor should be able to protect herself and her professional reputation and withdraw from representation in a way that most benefits their true client, the corporation.

As long as officers' and executives' jobs are on the line, or as long as owners of public corporations control the boards, there will always be a temptation to act fraudulently. When officers, executives, and directors fail to resist the temptation, the only remaining protections for investors are the lawyers. Senator Edwards said, "The truth is that executives and accountants do not work alone. Anybody who works in corporate America knows that whenever you see corporate executives and accountants working, lawyers are virtually always there looking over their shoulder."[257] Senator Jon Corzine, a former corporate lawyer, said, "We cannot overlook the role corporate lawyers . . . play in addressing abuses and ensuring that our markets have integrity."[258]

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[256] *Id.*
[257] 148 CONG. REC. S6524 (daily ed. July 10, 2002) (remarks by Senator John Edwards).
[258] *Id.* (remarks by Senator Jon Corzine).

Focusing on lawyers is an appropriate way to prevent corporate fraud. Setting up a framework where lawyers and solicitors have a clear understanding of who their client is, what their duties to their client are, which rules of professional conduct apply, and a certainty of enforcement of these rules will strengthen any financial market. Hong Kong has half the necessary pieces. The United States has the other half. By learning from each other, they could both build effective markets of the highest integrity, which would be a safe haven for investors, corporations, and legal professionals.